NO. 18628

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

WILL FLITCROFT and AGNES D. FLITCROFT,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF FOR PETITIONERS

ON PETITION
FOR REVIEW OF DECISION OF
THE TAX COURT OF THE UNITED STATES

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OPINION BELOW

The opinion of the Tax Court is reproduced on pages 217 to 247 of the Record.

JURISDICTION

The jurisdictional matters are set forth on pages 1-3 of Petitioners' Opening Brief.

QUESTIONS PRESENTED

The questions presented are those set forth on pages 12 and 13 of Petitioners' Opening Brief, with the exception that by his new legal theory, hereinafter discussed, respondent concedes that the partnership, Western Hydraulics, was entitled to deduct the rent paid by it from its gross income.

STATEMENT

The Tax Court found as a fact that during the years 1953 through 1956, Miers was paid a fee of $60 per day or approximately $900. 00 per month for the services he rendered Western Hydraulics (R. 225-226). Richard H. Miers testified that he averaged more than 40 hours a week in the service of Western Hydraulic (R. 144). Miers further testified that he received the prevailing accounting fee of $60. 00 per day from Western Hydraulic (R. 187). In addition to the fee of $60. 00 per day, the trust agreements (Exhibits 5, 6 and 20 Stip. Facts) did provide in Article VI for a trustee's fee to Miers commencing at 4% of the first $25, 000. 00 of the income for each trust (Exhibits 5, 6 and 20).

SUMMARY OF ARGUMENT

The Tax Court itself has abandoned the position it took in the Flitcroft case by its holding in the case of Mary Kent Miller

(Decided August 14, 1963, Para. 63, 215 P.H. Memo T.C.) that the decision of a Texas State Court that a trust was irrevocable is binding upon the Tax Court.

The taxability of the income from the Flitcroft trust is to be determined by the rules in effect under the Internal Revenue Code of 1939.

The cases here on review are in essence family partnership cases in which the principal question is that of whether the trustee-partner owned a capital interest in the partnership of Western Hydraulic and Service Company. Petitioners contend that they transferred a capital interest in the partnership to two trusts created for their children and therefore §704(e) of the Internal Revenue Code of 1954 requires that the trusts be recognized as partners. The partner-trusts were created in order to obtain and did in fact obtain and retain the services of Richard H. Miers, the trustee in the petitioners' business, were for the benefit of the grantors within the meaning of §2250 of the California Civil Code, had terms in excess of ten years and were not revocable trusts within the meaning of either §2280 of the California Civil Code or §673(a) of the Internal Revenue Code of 1954 which codified the "Clifford regulations".

A second question, belatedly raised by the respondent, is that of whether rent paid by the partnership to a trust created on October 1, 1953, by the taxpayers constitutes income to the petitioners. The petitioners contend the rent was income to the trusts and not to themselves.

ARGUMENT

I

THE TAX COURT ERRONEOUSLY HELD THAT THE INCOME OF THREE TRUSTS CREATED FOR THE BENEFIT OF PETITIONERS' CHILDREN WAS INCLUDABLE IN TAXPAYERS' GROSS INCOME IN THE YEARS 1954, 1955 AND 1956.

In a Memorandum Opinion rendered in the case of Mary Kent Miller on August 14, 1963, the Tax Court (Para. 63, 215 P. H. Memo T. C. Decision) has corrected the fundamental error it made in the pending case but at the same time sought to distinguish that case from the present "without a difference". It said of Will Flitcroft, 39 T. C. 52 (1962) on appeal (CA-9, March 11, 1963):

> "A 1961 California Court judgment reforming the trust instruments and ordering that the trusts were irrevocable from their inception was held to be not binding because it was obtained at the creator's request and was in a limited sense collusive."

The distinction does not exist. It was the trustees and beneficiaries, not the creators who obtained the judgment in the Flitcroft case, (Botsford v. Riddell, CA-9, 283 F. 2d 298, 6 AFTR 2d 6185 Ex. 13). The Tax Court said in its opinion in the Miller case, supra:

> "The taxability to petitioner of the income received by the Trustee in 1959 and 1960 depends upon whether she,

as Grantor, had the power to revoke the trust within 10 years from the date it was created. The possibility of the Trust property revesting in petitioner is a matter of State, not Federal, law. Blair v. Commissioner, 300 U.S. 5 (18 AFTR 1132)(1936); Helvering v. Stuart, 317 U.S. 154 (29 AFTR 1209)(1942).

"In this proceeding it must be determined by the laws of the State of Texas.

"Petitioner contends that the trust is irrevocable for a period of 10 years from the date of the transfer to the trust of its corpus and she relies primarily upon the judgment of the State Court as being determinative of the very issue before us. It is true that a matter of State law decided by a court of competent jurisdiction in an adversary proceeding determines the rights of the parties and is, to that extent, binding and conclusive with respect to tax liability. Freuler v. Helvering, 291 U.S. 35 (13 AFTR 834)(1934); Helvering v. Rhodes' Estate, 117 F. 2d 509 (26 AFTR 440)(CA-8, 1941), affirming 41 B.T.A. 62 (1940). However, where the State Court judgment is obtained through "collusion" for the purpose of avoiding tax liability, it has no binding effect on the Commissioner. Blair v. Commissioner, supra, Saulsbury v. United States, 199 F. 2d 578 (42 AFTR 728)(CA-5, 1952), certiorari denied 345 U.S. 906 (1953). Since the law presumes that court proceedings are regular and valid, we think in a situation like this, where "collusion" is asserted by respondent, it is incumbent upon him to produce at least some evidence to that effect. But here he has not done

so. He merely urges us to find that there was 'no necessity or reason for the State Court judgment except for its effect on the Federal tax question, and all of the parties to the state court action were undoubtedly aware of the position that respondent was going to take'. This alone, in our opinion, is insufficient to give the State Court proceeding a collusive, non-adversary character. Nor was it any less adversary because the statutory notice of deficiency was issued prior to the State Court judgment. Obviously, it was to avoid the possibility of respondent charging that silence is evidence of clandestine collusion that the Government was invited on March 14, 1962, to either intervene or otherwise assist in the State Court action.

"Being unable to find the solution to its dilemma in the conflicting opinions of its counsel and the Internal Revenue Service, and needing the correct answers, the Trustee obtained them from the only source available to it, the District Court of Midland County, Texas. The Trustee was not concerned with income tax liability. It had none whichever way the revocability issue went. It was concerned with real and tangible liability on its part.

"This is not the situation we had before us in Will Flitcroft, 39 T. C. 52 (1962), on appeal (CA-9, March 11, 1963), which is relied on by the respondent. In that case the creator was held taxable on the income of trusts created in 1953 for a term of 10 years and 5 days, where under California law the trusts were revocable until amendments in July 1954 expressly

made them irrevocable. A 1961 California court judgment reforming the trust instruments and ordering that the trusts were irrevocable from their inception was held to be not binding because it was obtained at the creator's request and was in a limited sense collusive."

The judgment entered by the District Court of Midland County recites that all parties were before the court, represented by independent counsel, the court had jurisdiction, a genuine and justifiable controversy existed and, after hearing arguments of counsel, it concluded that the trust is not "subject to revocation until after the expiration of 10 years from August 7, 1959". This judgment decided an issue regularly submitted and is not in any sense a consent decree pro forma. Following the mandate of the United States Supreme Court in Freuler v. Helvering, supra, we are unwilling under these circumstances to "impugn the good faith and judicial character of State Court's decree".

It is submitted that the Tax Court's decision in the pending case should be reversed on the basis of its subsequent decision in the case of Mary Kent Miller, supra, with instruction to hold and determine that trusts A and B, the partnership trusts, were established to have been at all times irrevocable, beyond dispute in the Tax Court, by the judgment of the Superior Court of California (Exhibit 13).

As a matter of California Statutory law the two Flitcroft trusts were also irrevocable because they were created for the benefit of the grantors; by their creation the grantors obtained the valuable service of Richard H. Miers in their business, §2250 California Civil Code. This alone is sufficient to support the Judgment (Exhibit 13)

rendered by the Superior Court of California.

Petitioners still contend as they did in their opening brief that the trust to which the rent was paid was an irrevocable trust and under the rule of the case of Commissioner v. Clark (1953) CA-7, 202 F. 2d 94, 43 AFTR 259, affirming 17 T. C. 1357 that the income of that trust is not taxable to these petitioners, the grantors of the trust. They have never contended that this, the C trust, was a partner in Western Hydraulic and Service Company or that its creation was used as an inducement to bring and hold the badly needed services of Richard H. Miers for petitioners' business.

Title to the business location property and the lease thereon were conveyed to Richard H. Miers as trustee of the joint or C trust by the grantors for the benefit of their two children. Petitioners contend the income of this trust was not taxable to them under the rationale of the case of Commissioner v. Clark (1953) 202 F. 2d 94, 43 AFTR 259, affirming 17 T. C. 1357. This case is fully discussed on pages 29-35 of petitioners' opening brief to which reference is here made.

The respondent's brief cites Reinecke v. Smith, 289 U. S. 172 175 (p. 24 Br.) for the proposition that the taxability of the income of the 1953 trusts is governed by the provisions of the Internal Revenue Code of 1954.

If the respondent places reliance upon §673(a) of the Internal Revenue Code of 1954, he "leans upon a broken reed". It is inapplicable to the Flitcroft Trusts as they were expressly made irrevocable before the 1954 Code became effective and §7851(a)(2)(B) of the 1954

Code provides:

> "(b) Chapter 12 of this title shall apply with respect to the calendar year 1955 and all calendar years thereafter, and with respect to such years chapter 4 of the Internal Revenue Code of 1939 is hereby repealed. '(b) Effect of Repeal of Internal Revenue Code of 1939. -(1) Existing rights and liabilities. - The repeal of any provision of the Internal Revenue Code of 1939 shall not affect any act done or any right accruing or accrued, or any suit or proceeding had or commenced in any civil cause before such repeal, but all rights and liabilities under such code shall continue, and may be enforced in the same manner, as if such repeal had not been made'."

The Clark case, supra, did not go to the Supreme Court; no decision refusing to follow it is to be found.

Congress might have made the provisions of the Internal Revenue Code of 1954 controlling as to rights accrued before its enactment but it expressly refrained from so doing when it enacted §7851(a)(2)(B) of that Code.

Footnote 1 on pages 22 and 23 of respondent's brief discloses that he has abandoned his original and insupportable legal theory, with respect to the joint trust created on October 1, 1953, that rent paid by the partnership, Western Hydraulics, for the use of its business property is not a proper deduction from the partnership gross income. Well he might abandon the legal theory of his

deficiency notice for it is squarely contra the provisions of §23(a)(1)(A) of the Internal Revenue Code of 1939 as well as those found in §162(a)(3) of the Internal Revenue Code of 1954. This original, insupportable, and now abandoned, legal theory of the respondent says has been replaced by a new one. The new legal theory was not heretofore recognized by the petitioners as a legal theory and it is true it was not discussed in their reply brief in the Tax Court nor did they do so in their opening brief in this Court. Not until receipt of the respondent's brief in this Court did petitioners or their counsel realize that the respondent was relying upon a new legal theory. Otherwise no space would have been given the old theory in their brief (See pages 56-59). His concession that the deficiency notices were erroneous places the burden of proof upon him as to the new issue. Lesley Cohen v. Commissioner (1959), CA-9, 265 F. 2d 5, 3 AFTR 2d 1157; Eva Rubin v. Commissioner (1963) 63-218 P. H. Memo T. C.

The petitioners find fault with respondent's "new legal theory". First because of some misstatement of fact made to both the Tax Court and to the Appellate Court in support of the theory. The Commissioner's opening brief in the Tax Court is not before this Court as a part of the record on appeal and therefore cannot be intelligently discussed (See Rule 18(e) of CA-9). But accepting the statement from that brief quoted in footnote 1 of respondent's brief in this Court:

> "The broad question presented for the court's determination in these consolidated cases is whether partnership income reported by three trusts created by

petitioners (taxpayers) for the benefit of their two children is taxable to petitioners in the years 1954, 1955 and 1956."
(Emphasis supplied).

as an accurate quotation the misstatement of fact in the Commissioner's brief before the Tax Court is disclosed. Only two, not three trusts reported any partnership income (R. 56, 57(9), R. 55(3), Exhibits 5 and 6, R. 57(13), Exhibits 17, 18, 19, 20, 26F Schedule K, 27G Schedule K, 28H Schedule K, Pet. Exhibits 37 Schedule A, 38 Schedule A, 39 Item 5, 40 Item 5, 41 Item 5, 42 Item 5, 43 Item 5, 44 Item 5). The third or joint trust reported no income from any partnership but did report income from rent in each of the taxable years here involved (Pet. Exhibits 4 and 5, Item 6, Exhibit 46 Item 6). It is only this trust that is involved in the so-called new legal theory.

A second misstatement of fact is made to this Court in the portion of the footnote found on page 23 of respondent's brief. It reads:

> "Thus, instead of disallowing to the partnership the deductions for rent and thereby increasing both its net income and taxpayers' distributive share of this income, the Commissioner allowed the rental deduction to the partnership but included the rental payments to the joint trust in taxpayers' gross income."

The Tax Court's decisions made no adjustments to the taxable income shown in the deficiency notices (R. 248 and 250, R. 253 and 255). The deficiency did not allow any rental deduction to the partnership,

nor did the Tax Court find that the Commissioner had done so. The Tax Court found it to be a fact that: "In each instance respondent gave as an explanation for the disallowance of the claimed deduction for rent that the amount claimed to be paid to the trust for petitioners' minor son and daughter was not a deductible business expense of the partnership." (R. 233). The record here contains nothing to the contrary.

Petitioners accept respondent's abandonment of his contention that the rental payments should be disallowed as a business expense of the partnership. If payment of rent to themselves produces income the respondent's new legal theory has the effect of doubling the income charged to petitioners from the rent.

The Commissioner must plead affirmatively, assume the burden of proof, and, if necessary, claim an increased (deficiency) whenever he asks the Court to take a position inconsistent with that taken in determining the deficiency. Rubin v. Commissioner (1963) para. 63, 218 of Prentice-Hall Memo T. C. Decisions. This the respondent has not done. It is submitted that the record before this Court is insufficient to bring respondent's "new legal theory" before it.

The respondent's brief (p. 28) attacks the judgment of the California Court which reformed the partner-trust agreements as being collusive on two grounds.

First that the taxpayers secured the order of reformation to reduce their federal tax liability. This contention is based on the false premise that the taxpayers secured the order of reformation. There is not a scintilla of evidence in the record to support that

statement. On the contrary the evidence is clear and undisputed that it was the trustees and the beneficiaries of the trusts, not the grantors who are here called taxpayers, who obtained the order of reformation (Exhibits 11, 12, 13 and also Botsford v. Riddell (1960) CA-9, 283 F. 2d 298). The Tax Court has given an adverse answer to a similar contention in the case of Mary Kent Miller, 63-215 P. H. Tax Court Memo Decision.

Secondly that the answer filed by the taxpayers in the Superior Court of the State of California failed to state facts sufficient to constitute a defense to the complaint or any portion thereof (Exhibit 13). Defendants can lose a lawsuit in at least two ways. One, they may not, within the outer limits of truth, be able to state facts in their answer sufficient to constitute a defense to the complaint. Two, they may state facts in their answer sufficient to constitute a defense to the complaint but fail to prove the facts alleged. Honest pleading is to be commended. It conserves the time of courts. It is not an emblem of collusion. Respondent's brief fails to point out any facts that could truthfully have been stated in taxpayers' answer that were not stated therein by them. The Internal Revenue Service was thoroughly aware of the allegations of the trustees' complaint. Botsford v. Riddell, supra. If it had any question about the sufficiency of the defendant's answer, it was free to intervene and file and answer of its own. Rule 24, Federal Rules of Civil Procedure.

In footnote 5 on page 31 of respondent's brief the unique proposition is advanced that the trust agreements (Exhibits 5 and 6) are not "written contracts" and therefore §3399 of the California

Civil Code has no application. The brief cites Gaylord v. Commissioner CA-9, 153 F. 2d 408, 415 as supporting this contention. The trusts in the Gaylord case had no diversity of parties. The grantor and trustee were the same person. The California statutes provide that it is essential to the existence of a contract that there be a plurality of parties. §1550(1) California Civil Code. There was no plurality of parties in the Gaylord case. Reference to the partner-trust agreements (Exhibits 5 and 6) in the present case will disclose that the grantors and trustee were not the same person. Here the Tax Court has found and the evidence shows the transaction not to be shams and that an independent trustee controlled the trust corpus (R. 234). It is submitted that §3399 of California Civil Code applies rather than the holding of Gaylord, supra, for the reason that here there was in fact a plurality of independent parties to the trust agreements. There were written contracts with a diversity of parties (Exhibits 5, 6, R. 234).

Respondent's brief "begs the question" presented in this case when it says (p. 31): "But the reformation cannot occur in such a way as to defeat the already accrued rights of a third party -- in this case the United States." It is submitted that no rights had accrued to the United States if grounds for reformation did otherwise exist. It had no vested right in an error that occurred in a lawyer's office whereby the intention of the parties to a written contract was thwarted and failed to be truly expressed. The lawyer had failed to give the required attention to §2280 of the Civil Code of California when he drew the trust agreements. He admitted and corrected the

error in draftsmanship as soon as it was called to his attention (Exhibits 31-K, 32-L). If the parties created irrevocable trusts on January 1, 1953, and the judgment of the California Court has said they did so, the asserted tax rights of the United States never did accrue as to those trusts. §3399 Civil Code of California.

Respondent's brief cites the case of Title Insurance and Trust Company v. McGraw 72 Cal. App. 2d 290, in support of a contention that no consideration passed to the grantors in the Flitcroft partner-trusts. It is true that in the McGraw case the trial Court found there was no consideration for a deed and gave a judgment rescinding the deed. The judgment was affirmed on appeal. The case is not here in point on the facts. The trial Court of California has found the Flitcroft partner-trusts to be irrevocable from their inception. The trial Court of California found the McGraw trusts to be revocable. The law presumes that Court proceedings are regular and valid.

CONCLUSION

It is respectfully submitted that the decisions of the Tax Court should be reversed.

Respectfully submitted,

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CERTIFICATE

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit and that in my opinion this brief is in full compliance with those rules.

/s/ Ernest R. Mortenson
ERNEST R. MORTENSON